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INSIGHTS ON...

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Structural change in the financial operations of Canadian insurance companies

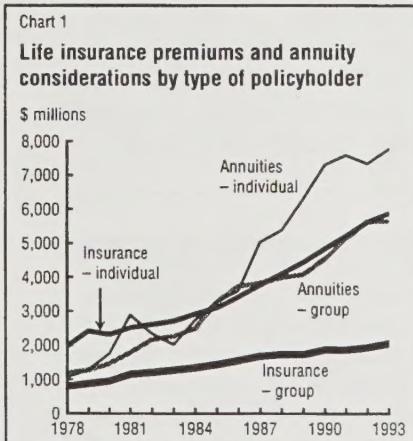
By Tarek M. Harchoui*

'The trade of insurance gives great security to the fortunes of private people, and by dividing among a great many that loss which would ruin an individual, makes it fall light and easy upon the whole society. In order to give this security, however, it is necessary that the insurers should have a very large capital.'
(Adam Smith; *Wealth of Nations, Book V, Chapter 1*).

Although the fundamentals of the insurance business remain largely unchanged from Adam Smith's day, the market for financial protection has, for some time, been undergoing significant change. Since the early 1980s, regulatory and tax reforms have given rise to increased competition among financial institutions. Insurance companies, in particular, have faced intense competition for contractual savings from a broad variety of tax-sheltered investment vehicles offered by mutual funds and trustee pension funds. This article shows that insurance companies have responded by increasing their financial intermediation activities, particularly through the sale of annuities and RRSPs, and have managed to preserve their market share in an increasingly competitive marketplace. In an appendix, the article also shows differences between the financial structure of insurance companies in Canada and other industrialized countries.

Operations of Canadian insurance companies

Annuities¹ are the principal source of revenues for life insurance companies, although insurance premiums are also significant. From 1978 to 1995, annuities represented some 57% of life insurance companies' net revenues. Revenue from annuities dropped during the early 1980s under the combined effects of the recession and the discontinuation of favourable tax treatment for income averaging annuities. However, they rebounded strongly through the latter half of the decade (Chart 1). Insurance



¹ An annuity is a contract that provides income payments at regular intervals, usually for a specified period or for the lifetime of the annuitant. Income payments may begin right away or be postponed to some future date.

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INSIGHTS ON...

In this issue...

Structural change in the financial operations of Canadian insurance companies

— in this article, the author shows how insurance companies, by increasing their financial intermediation activities through the sale of annuities and Registered Retirement Savings Plans, have managed to preserve their market share in an increasingly competitive marketplace.

Appendix

— Financial structure of insurance companies: international comparisons.

Aussi disponible en français



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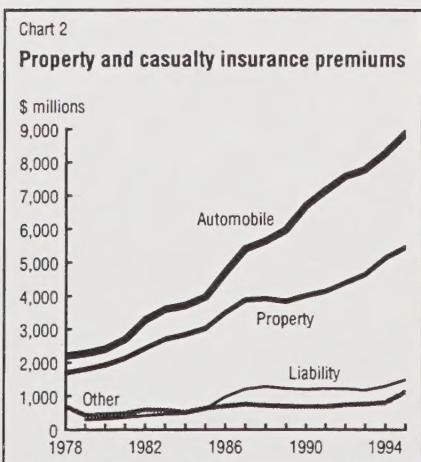
premiums, in contrast, rose steadily from 1978 to 1995, largely unaffected by the business cycle. Over the 1978-95 period as a whole, annuities boosted the revenue flows of life insurance companies, growing at an average annual rate of 10.7%, as opposed to 7.8% for insurance premiums.

Tax treatment has had a profound effect on the demand for life insurance and annuities. Demand for income-averaging annuities boomed during the 1970s, but dropped sharply in 1981 when the tax rules were changed.

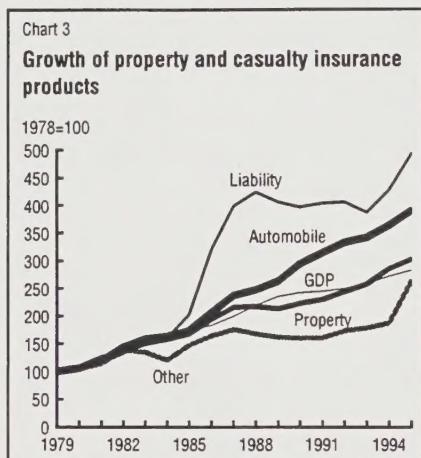
Subsequently, however, the introduction of tax-sheltered registered retirement saving plans (RRSPs) created a renewed demand for annuities, both by individuals who initially register their RRSPs with a life insurance company and by those who purchase a life annuity upon the maturity of an RRSP registered with a different class of financial institution.

Non-life insurance companies expanded at a slower rate than life companies between 1978 and 1995. In 1978, net premiums for non-life insurance companies were equivalent to slightly more than 75% of those for life insurers, but by 1995 the proportion had slipped to 66%.

The most important non-life insurance products are automobile, liability and property insurance, which represent some 80% of non-life insurance premiums. The remaining 20% includes a wide variety of insurance, from marine to accident and sickness (Chart 2).



Liability insurance, which provides protection against damages as a result of professional and non-professional activities, has experienced rapid growth since 1986, but remains modest in absolute terms (Chart 3). In 1995, net premiums totalled approximately \$1.5 billion, or 8.8% of total revenues of non-life companies. Automobile insurance has also shown lively growth, rising at an average annual rate of 8.9%. It is the largest category of non-life insurance, well ahead of property insurance, the next largest category.



Competition in the market for financial security

There has been strong competition in the market for financial protection over the past two decades. Life insurance was at one time virtually the only form of long-term contractual saving

available, but in recent years a number of alternatives have emerged. Sparked by tax incentives, mutual funds and pension funds have aggressively tapped the market for long-term financial security, while increased competition has also come from more conventional savings vehicles such as term deposits at banks and trust companies and Canada Savings Bonds.

As a result, there has been a decline in the proportion of personal savings being channelled into insurance products. In the early 1960s, approximately 44% of personal savings went into life insurance each year. By the 1990s, this had fallen to 22% of personal savings. Moreover, over the same period, the share of personal savings going towards RRSPs more than doubled. In other words, rather than buying insurance with an in-built savings component, consumers were opting for more basic insurance coverage, and investing the rest of their savings through alternative investment vehicles.

Of the many savings vehicles, RRSPs are the most popular. They are offered by many different financial institutions, and competition to administer savers' assets is intense. These tax-sheltered investment plans encourage saving by providing tax deferrals on contributions and investment income. Investments qualifying for inclusion in an RRSP cover a wide range of assets, but must meet certain criteria – for example, marketable securities are eligible for inclusion in RRSPs, but no more than

Table 1
RRSPs* of Individuals and Unincorporated Businesses by Type of Financial Institution (%)

	1980	1986	1990	1995
Life insurance companies**	22.8	17.3	21.0	19.9
Chartered banks	19.0	28.1	32.0	36.1
Trust and mortgage loan companies	30.7	28.7	25.6	10.0
Credit unions & caisses populaires	15.3	13.5	11.9	10.7
Mutual funds	12.2	12.4	9.6	23.3
Total	100.0	100.0	100.0	100.0

* Excludes self-directed RRSPs.

** Includes Segregated Funds.

Source: Statistics Canada; Canadian National Balance Sheet Accounts (Catalogue no. 13-214-XPB).

Financial characteristics of insurance companies

Insurance companies transform liabilities into earning assets by acquiring funds at periodic intervals on a contractual basis and investing them in portfolios of financial assets. Insurance premiums and annuity contributions are the principal sources of insurance funds. The existence of a time lag between the receipt of cash premiums and payment of claims allows insurance companies to channel the revenues to other sectors of the economy via the acquisition of financial assets. This process of financial intermediation in turn helps finance the accumulation of capital and promote economic growth.

By holding a large, diversified portfolio of assets, a financial intermediary takes advantage of economies of scale and spreads risk. An insurance policy is a claim on an insurance company, albeit a contingent one. However, the insurance company cannot know with certainty the claims for payment that will be made under outstanding policies during any period of time. As a result, insurance companies accumulate large pools of capital to guarantee their ability to honour future claims.

Life and non-life insurance

Insurance companies are of two basic types: life (offering individual and group life policies, accident and sickness insurance, annuities and pension fund management) and non-life (whose business consists mostly of vehicle, property and liability insurance). There are a number of important distinctions between them. Life insurance companies deal mainly with households, whereas non-life insurance companies also provide services to the business sector. Non-life contracts are typically written to cover a period of one year, or even part of a year, whereas a life insurance policy normally covers a much longer period.

Differences in the maturities of the two types of policies call for differences in the composition of assets held by life and non-life companies. Forecasts of future claims on non-life

insurance are subject to a greater degree of uncertainty, both in terms of timing and amount, than for life insurance. A non-life insurer may face an exceptionally high level of claims without warning, and may need to liquidate assets at very short notice to pay off claims. It thus requires assets that possess a relatively high degree of liquidity, such as highly marketable bonds and money market instruments.

Moreover, non-life insurance companies that underwrite very large-scale risks will need a more liquid mix of assets than companies that mainly underwrite insurance for individuals, where the laws of large numbers make large-scale claims less likely.

In contrast, life insurance companies handle claims that typically arise after the lapse of a considerable length of time, and so invest in financial instruments of a much longer duration, particularly where their business consists of long-term saving and retirement provisions.

As well as the need to match the maturity structure of assets and actuarial liabilities, the investment portfolios of insurance companies are heavily influenced by government regulation. The regulatory framework restricts bond and stock investments to securities issued by companies satisfying stipulated conditions of financial strength, and mortgages to a proportion of the value of the secured property.

For life insurance contracts that possess a significant long-term savings element, there will also be a concern for maintaining the long-term purchasing power of invested funds. In this context, earning a rate of return at least equal to inflation is less a contractual requirement than a competitive one. Investments in equities and real estate, which tend to be more highly correlated with inflation and longer-term economic growth, will constitute a larger proportion of the assets held against these policies, as will index-linked bonds.

20% of the book value of assets may be invested in foreign stocks. Over the years, the rules governing RRSPs were made more flexible and the maximum contributions increased. At the same time marginal tax rates rose, making RRSPs even more attractive.

RRSPs grew at an average annual rate of 11.8% from 1978 to 1995. By 1995, the chartered banks had captured the

largest single share of RRSPs under administration, with 36.1% of the total, followed by mutual funds (23.3%) and life insurance companies (19.9%). Over the period from 1980 to 1995, chartered banks and mutual funds saw their shares of total RRSPs under administration almost double, mainly at the expense of trust and mortgage loan companies (Table 1).

With the increased popularity of RRSPs, life insurance policies have represented a declining share of life insurance companies' revenues. In an attempt to recover lost ground, life insurance companies have become increasingly active in marketing RRSPs. Annuities and life insurance policies are both eligible for inclusion in RRSPs; in fact, RRSPs administered by life insurance

companies are mainly composed of annuities. Life insurance companies have also benefited from the redemption of RRSPs. Although RRSPs provide tax deferrals, they must eventually be cashed in. At that point they are also taxed, unless converted into a registered retirement investment fund (RRIF) or an annuity. Annuities, which can only be offered by life insurance companies, have proven to be the more popular.

In response to competitive pressures, insurance companies have also developed a variety of new products known as 'new money policies' (universal life, limited payment life, level or decreasing term) with comparable rates of return to other kinds of savings vehicles. Essentially, the savings elements of these products pay interest rates that reflect changing market conditions. They also allow the policyholder to vary the amount and timing of premium payments and change the amount of insurance.

From 1978 to 1995, the strong demand for RRSPs saw mutual funds grow at an average annual rate of 24.0%, compared to 12.8% for trustee pension plans, 9.9% for life insurance, 9.4% for property and casualty insurance, and 8.7% for chartered banks and *caisses populaires*. Over this period, mutual funds increased their market share from 11.1% to 18.8%, compared to a corresponding increase for trustee pension funds from 1.1% to 9.2% and declining market shares for chartered banks, trust companies, investment dealers, and sales finance and loan companies. Over the same period insurance companies' market share remained unchanged, however.

Portfolio structure of insurance companies

a. Life insurance companies

Mortgages and bonds comprise three quarters of the investment portfolios of

life insurance companies (Table 2). Between 1978 and 1995, the relative importance of mortgages declined from 43% to 35% of total assets, while bond holdings increased. The smaller mortgage component reflected amendments to the *National Housing Act*, permitting the amortization period for residential mortgages to differ from their terms. As a result, under the new rules, mortgage loans were less well suited to life insurance companies' needs for a long-term asset matching their long-term liabilities.

Among bond holdings, Government of Canada bonds doubled as a share of life insurance company assets from 1978 to 1995. The increase was offset by a significant reduction in holdings of corporate bonds, while provincial bonds also edged downwards.

Loans to underwriters of insurance policies declined from 5.2% to 2.5% of total assets between 1978 and 1995. The decline reflects the reduced popularity of whole-life policies, which allow insurance companies to lend funds to policyholders at a predetermined rate up to the cash value of the policy. Loans against whole-life policies, which are included in loans to underwriters,

became increasingly attractive as bank interest rates increased during the 1980s. With the decline in interest rates in recent years and the shift in consumer preferences for term insurance, the importance of loans to underwriters of insurance policies has declined.

The percentage of assets invested in equities – always relatively small and far less than the 20% limit allowed by the regulatory authorities – declined from 6.0% of total financial assets in 1978 to 4.8% in 1995. It peaked at 6.6% in 1987, but declined thereafter following the 1987 stock market shock.

Two asset classes increased substantially. Foreign asset holdings, although only 0.4% of assets, tripled their share from 1978 to 1995, while "other" financial assets, comprised mainly of short-term assets, more than doubled their share from 6.4% to 14.8% of total assets over the same period.

b. Non-life insurance companies

Assets of non-life insurance companies are invested mainly in bonds, stocks and short-term assets (bank deposits, Treasury bills and short-term paper) (Table 3). The percentage of assets

Table 2
Assets Structure of Life Insurers (%)

	1978	1980	1985	1990	1995
Financial Assets	90.2	89.8	90.3	92.5	94.0
Loans to Policyholders	5.2	5.6	4.6	2.9	2.5
Mortgages	42.9	42.7	34.5	41.5	35.0
Bonds	39.1	38.1	41.3	34.6	42.0
Government of Canada Bonds	12.2	17.8	28.9	20.2	24.5
Provincial Bonds	22.3	19.1	19.7	13.7	20.0
Municipal Bonds	6.4	6.3	6.0	5.1	5.7
Other Bonds	59.1	56.8	45.4	60.9	51.0
Shares	6.0	6.0	6.0	6.0	4.8
Foreign Investment	0.4	0.3	0.5	1.3	1.3
Other Financial Assets	6.4	7.2	13.1	13.7	14.8
Non-Financial Assets	9.8	10.2	9.7	7.5	6.0
Total Assets	100.0	100.0	100.0	100.0	100.0

Source: Statistics Canada; Canadian National Balance Sheet Accounts (Catalogue no. 13-214-XPB).

invested in bonds declined from 56.2% in 1978 to 51.3% in 1995. However, federal government bonds increased their share of total assets by more than 50% while all other types of bonds declined. The share of assets invested in stocks remained more or less constant, while short-term assets, which are required to meet liquidity needs as well as to match the terms of assets and liabilities, increased their share by approximately 8 percentage points.

Summary

- After declining for 20 years, the revenue sources of insurance companies maintained their market share from 1978 to 1995.
- The popularity of whole-life insurance policies declined from 1978 to 1995 in favour of term insurance, while investment in annuities (especially individual annuities) increased at the expense of life insurance products.
- Liability insurance (providing protection against damages by third parties) has been the fastest growing product line for non-life insurance companies, outstripping automobile and property insurance, particularly in the period since the mid-1980s.
- Tax incentives have encouraged dynamic growth in individual savings through RRSPs and annuities. In

Table 3

Assets Structure of Property and Casualty Insurers (%)

	1978	1980	1985	1990	1995
Financial Assets	98.0	97.1	96.9	97.6	98.0
Mortgages	3.6	3.6	2.2	2.3	1.7
Bonds	56.2	52.9	50.6	52.9	51.3
Government of Canada Bonds	30.6	38.8	42.8	41.4	49.8
Provincial Bonds	28.3	25.1	26.4	22.7	21.0
Municipal Bonds	9.2	8.6	8.1	7.6	7.0
Other Bonds	31.9	27.6	22.8	28.3	22.2
Shares	12.7	14.4	13.6	12.7	11.2
Foreign Investment	1.3	1.3	1.0	1.0	1.2
Other Financial Assets	26.3	27.9	32.7	31.0	34.3
Non-Financial Assets	2.0	2.9	3.1	2.4	2.0
Total Assets	100.0	100.0	100.0	100.0	100.0

Source: Statistics Canada, Canadian National Balance Sheet Accounts (Catalogue no. 13-214-XPB).

recent years, chartered banks and mutual funds have captured more than 55% of the demand for RRSPs, followed by life insurance companies (together with their segregated funds) with a 20% share.

- The asset structure of life and non-life companies reflects the differing characteristics of their respective product lines. Life insurance companies prefer long-term assets to match the maturity of their liabilities and provide returns that maintain purchasing power. Non-life insurance companies generally prefer more liquid assets to meet claims that may arise in the short term.

Data sources:

The data sources used in this article include:

- Statistics Canada, *Quarterly Financial Statistics for Enterprises* (Catalogue no. 61-008-XPB)
- Statistics Canada, *National Balance Sheet Accounts* (Catalogue no. 13-214-XPB)
- Canadian Life and Health Insurance Association (1994), *Canadian Life and Health Insurance Facts*, Annual, Toronto.
- OECD (1995), *Insurance Statistics Yearbook, 1986-1993*, Paris.

From the Editor's desk...

Please note that this is the first issue of *Insights On...* since the Fall 1996 edition (Vol.1, No. 3).

In this edition, Tarek Harchaoui's article on "Structural change in the financial operations of Canadian insurance companies" is a shortened version of a paper he presented to Statistics Canada's business economics conference in September 1996.

Statistics Canada's 1997 economic conference – **Conference '97: Economic Growth and Employment** – will be held at the Château Laurier in Ottawa on September 29-30. For more information on Conference '97, please contact Mike Trant at (613)951-2859, or by e-mail at tranmik@statcan.ca.

Appendix

Financial structure of insurance companies: International comparisons

Insurance is highly international in scope. Many foreign insurance companies are active in Canada, and several of the larger Canadian life insurance companies write a substantial amount of their policies outside Canada. In the mid-1990s, of 153 life insurance companies in Canada, 77 were Canadian, 59 American, 10 British and 7 European. Similarly, of 217 non-life insurance companies, 108 were Canadian, 82 American, 22 British and 5 European. At the end of 1994, more than one-quarter of the life insurance policies and more than three-quarters of non-life policies in effect in Canada had been written by foreign-controlled companies.

National regulations play an important role in shaping the investment portfolios of insurance companies. Insurance

companies doing business in Canada, for instance, are required to register with the Superintendent of Financial Institutions and to maintain sufficient assets in Canada to cover their liabilities. Even among OECD countries, however, there are substantial differences in financial structure. Data presented here are for Canada, Australia, Switzerland, the Netherlands, France, the United Kingdom, Belgium, Italy, the United States, Germany and Japan, which together account for 86% of gross insurance premiums of all OECD countries. The data come from the *OECD Insurance Statistics Yearbook*, which provides information for each member country from 1986 onwards.

A. Distribution of Investment Portfolios of Life Insurance Companies as a Percentage of Total Assets

	Canada	United States	Australia	France	Germany	Italy	Nether-lands	Switzer-land	United Kingdom	Belgium
1988										
Real Estate	5.2	2.8	20.0	12.6	6.2	16.4	9.2	16.3	18.0	6.4
Mortgage Loans	38.0	23.3	2.7	0.0	15.2	4.7	22.2	21.3	2.0	22.7
Shares	7.5	5.5	40.9	21.3	3.4	11.6	9.5	4.5	53.1	14.3
Bonds with Fixed Revenue	43.2	56.6	15.3	58.0	24.3	65.5	9.0	40.3	23.2	48.2
Loans other than Mortgage										
Loans	5.4	5.5	4.2	7.8	47.8	0.0	47.1	15.4	1.4	1.4
Other Investments	0.7	6.3	16.8	0.4	3.0	1.9	2.9	2.2	2.3	7.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1991										
Real Estate	6.0	2.7	11.3	11.5	5.8	15.1	7.7	14.9	14.4	8.1
Mortgage Loans	38.4	20.4	0.0	0.0	14.8	5.5	18.3	21.1	1.4	21.0
Shares	9.0	5.4	32.4	20.1	4.0	9.6	9.9	6.7	55.4	13.2
Bonds with Fixed Revenue	41.6	60.5	19.6	60.7	14.6	67.0	16.9	37.9	24.1	48.0
Loans other than Mortgage										
Loans	4.2	5.0	5.7	2.8	47.4	0.0	42.1	15.8	2.2	2.3
Other Investments	0.8	6.0	31.1	5.0	13.5	2.7	5.0	3.5	2.4	7.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: OECD (1995)

- Except for Australia, the United Kingdom, Germany and the Netherlands, the majority of life insurance companies' investments (at least three quarters) are in real estate, mortgages and fixed rate bonds. Germany and the Netherlands show a significantly greater concentration of investments in

- non-mortgage loans than other countries.
- Life insurance companies in the United Kingdom and Australia invest a higher percentage of their assets in the stock market (41% and 53%, respectively).
- Of the 50 largest insurance companies in terms of assets, most

are based in the United States and Japan. Those in the United States account for 36% of the total, while Japanese firms account for a further 33%. In neither country, however, are more than 6% of assets invested in the stock market.

B. Distribution of Investment Portfolios of Non-Life Insurance Companies as a Percentage of Total Assets

	Canada	United States	Australia	France	Germany	Italy	Nether-lands	Switzer-land	United Kingdom	Belgium
1988										
Real Estate	0.9	2.8	7.8	16.5	7.7	18.8	5.1	13.4	18.0	6.4
Mortgage Loans	11.3	23.3	2.0	0.0	3.2	2.1	4.2	6.8	2.0	22.7
Shares	16.6	5.5	29.7	31.0	9.1	19.6	12.2	18.6	53.1	14.3
Bonds with Fixed Revenue	70.9	56.6	30.2	43.4	33.8	52.6	34.6	53.3	23.2	48.2
Loans other than Mortgage										
Loans	0.0	5.5	30.3	5.7	43.6	0.0	38.8	7.9	1.4	1.4
Other Investments	0.4	6.3	0.0	3.4	2.6	6.9	5.1	0.0	2.3	7.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1991										
Real Estate	1.1	2.7	5.5	15.6	7.8	20.6	4.7	14.9	14.4	8.1
Mortgage Loans	11.6	20.4	0.0	0.0	3.4	1.8	3.9	7.8	1.4	21.0
Shares	15.3	5.4	20.2	30.7	10.2	21.5	12.5	24.4	55.4	13.2
Bonds with Fixed Revenue	71.7	60.5	30.0	39.7	20.0	51.1	39.6	41.8	24.1	48.0
Loans other than Mortgage										
Loans	0.0	5.0	20.3	2.7	42.8	0.0	38.9	11.1	2.2	2.3
Other Investments	0.3	6.0	24.0	11.4	15.8	4.9	0.3	0.0	2.4	7.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: OECD (1995)

- In North America, insurance companies tend to use similar investment strategies, with almost identical asset structures in Canada and United States.
- Apart from Germany and the Netherlands, the financial structure of insurance companies in different EU countries differs significantly.
- Except for Germany, EU countries seem to have a more similar

investment strategy for non-life insurance investments than for life insurance investments.

- With the exception of Germany, the Netherlands and the United Kingdom, most insurance companies – both life and non-life – seem to prefer investing in fixed-rate bonds.
- Investments in stocks seem to be increasing for non-life insurance companies in continental European countries and in North America. In
- these countries in particular, investments in fixed-rate bonds by non-life insurance companies are twice those of their life insurance counterparts.
- Equity investments, although comprising fully 30% of the investment portfolios of non-life companies in Australia and the United Kingdom, represent a significantly smaller proportion for life insurance companies.

Summary

Government regulation affects the asset structure of insurance companies, but appears to have had a differing impact within the major industrialized countries. According to OECD statistics, most countries, including Canada, favour investment in less risky assets such as government bonds rather than stocks. In the United Kingdom and Australia, equity investments comprise a significantly higher proportion of insurance company portfolios than in most other OECD countries. The asset composition of Canadian and U.S. companies is highly comparable – much more so than is found among firms in different member countries of the European Union.

INSIGHTS ON...

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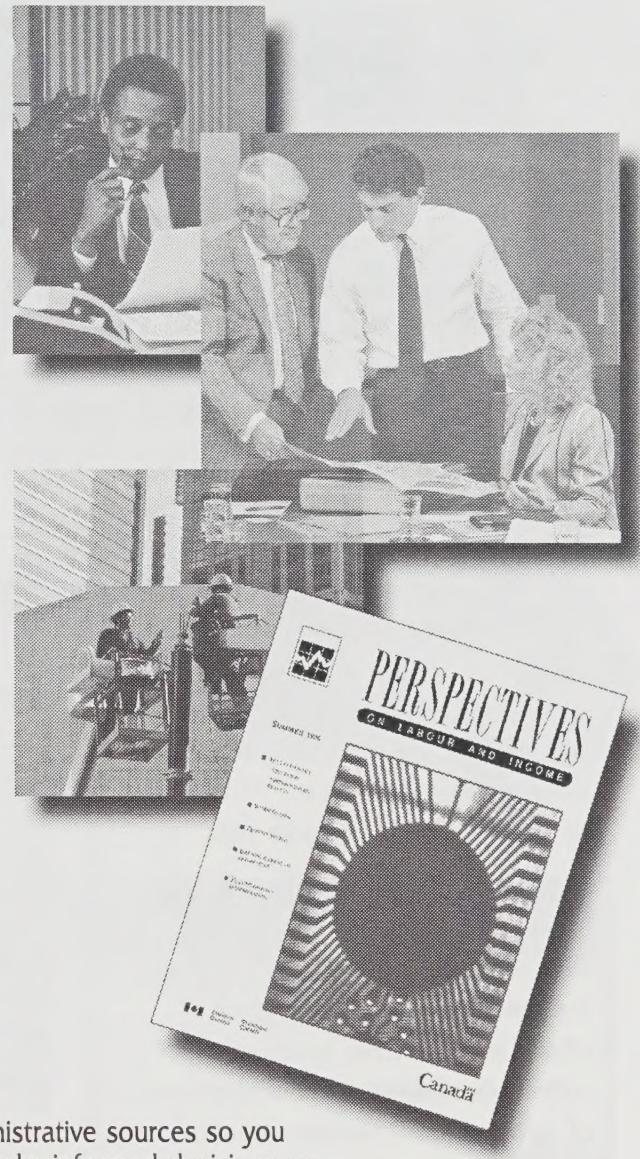


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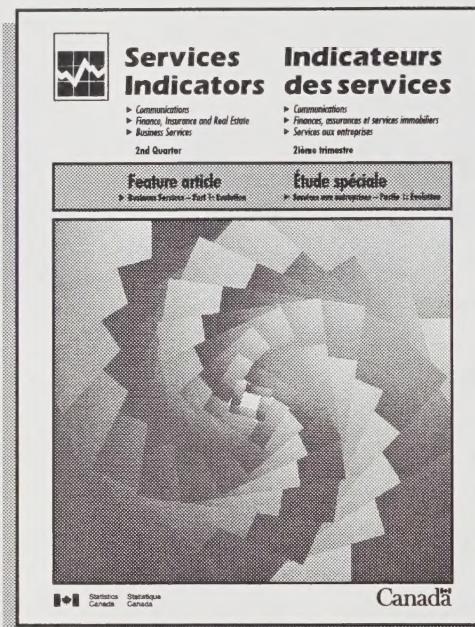
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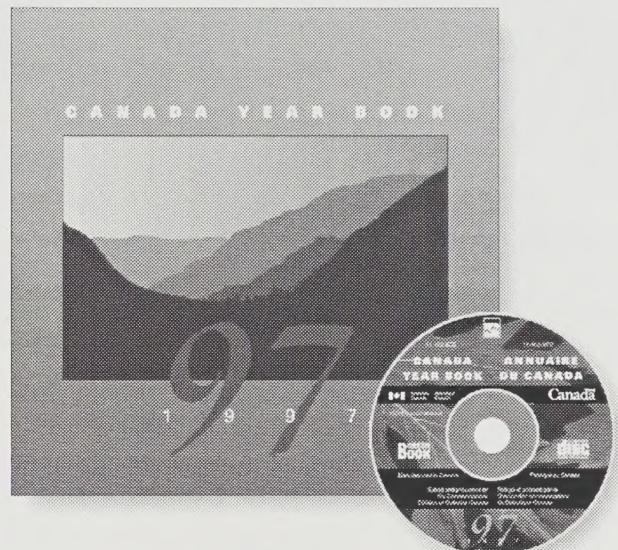
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